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SINO-JAPANESE RELATIONS:
ECONOMIC ADJUSTMENT FOLLOWS POLITICAL CHANGES

Summary

In 1980 for the first time, the two-way total of Sino-Japanese trade surpassed \$10 billion. The trend continued into 1981 but halted abruptly last year when the total plunged to \$8.8 billion, a decline of almost 15 percent. Since a long-term trade agreement was signed in 1978, Japan's reactions to China have ranged from euphoria to disillusionment, but have not affected the decision to assist in the modernization and industrialization of that country. This paper will analyze the overall economic relationship and problems that face the two nations. Further background is provided in JEI Report No. 27A, July 15, 1982.

Background

The bilateral economic relationship is hostage to China's political climate. With the emergence of Deng Xiaoping, the architect of modernization and industrialization, optimism prevailed. But when overly ambitious economic plans led to a change in policy, Japanese firms incurred serious losses from the cancellation of several large-scale projects. While the current political atmosphere in China is calm, press reports in the United States suggest that the tide might be changing.

The most politicized issue last year concerned the revision of some Japanese high school textbooks in which an attempt was made to soften the phrase describing the Japanese "invasion" of China to the bland "advancement". The Chinese formally protested this re-writing of history — a sentiment shared throughout Asia and not without support at home. Although conservatives argued that the country's educational policy should not be subject to political pressures from abroad, and particularly from a communist state,

the press was highly critical of this attempt to amend history and the issue was particularly embarrassing for the Japanese government, which was planning to commemorate the tenth anniversary of normalization of relations with China.

Then-premier Zenko Suzuki visited Peking in September and told the Chinese that Japan would not incorporate the language change and would not tolerate an upsurge of militarism. Mr. Suzuki asked for, and received, a promise that the Chinese would apply the rules of international commerce to foreign investment, and in return agreed to cooperate on oil exploration projects in the Bohai Bay. Possibilities seemed to be widening, and Shintaro Abe of the Ministry of International Trade and Industry (MITI) received assurances from Chinese officials that they would consider a resumption of construction of the Baoshan steel mill and some petrochemical plants — a piece of good news for Japan.

On September 23, a Japanese business delegation signed a second long-term trade agreement with China. The original 1978 agreement committed China to increase oil exports from 7 million metric tons to 15 million metric tons by 1982. Coal exports were to rise to 2 million metric tons of coking coal and 15-17 million metric tons of steam coal in the same period. These projections proved overly optimistic, and problems relating to aging oil fields, poor infrastructure and rising domestic consumption lowered 1982 shipments to 9.1 million metric tons of oil and 1.3 and 1.5 million metric tons of coking and steam coal, respectively. The new agreement targeted between 8 and 8.6 million tons of oil and 7 to 8 million tons of coal in 1983-85.¹

In December, cabinet-level economic meetings in Tokyo moved the two nations back to normal communications and both sides resumed talks on potential economic cooperation. Whether Peking's increasing denunciation of the United States will result in a tilt toward Japan for foreign investment and technical assistance is unclear. It is true that Japan does not have any burning political issues with China, in contrast with the United States, which is in conflict with Peking over arms sales to Taiwan and the recent question of political asylum. Japan's relationship with Taiwan — although strictly unofficial — is not an issue. Japanese firms with investments in Taiwan are moving into the Chinese market, but their ideological credentials are no longer a prerequisite for admission. At the same time, Japanese business executives do not underestimate the barriers of a communist state, and their understanding has become more sophisticated, more factual and more pragmatic.

Economic Conditions in China

In 1980, China's total population was estimated at 976 million, with a per-capita income of \$290 — one of the poorest of the developing countries in the region.² In early 1978, China's modernization began with an ambitious ten-year plan, concentrating primarily in heavy industries and imports of western technology. Almost immediately, a variety of adjustments were necessary. Steel industry development was cut back, and agriculture, light industry and infrastructure investments were increased. Imports of foreign technology went forward, but many projects that involved foreign interests were cancelled. The government's economic management skills proved unwieldy, and with a trade deficit, inflation, lower economic growth, a deteriorating agricultural sector and increasing unemployment, the government imposed an austere budget and drastically cut capital investment.

The new five-year plan (1981-1985) targets economic growth at 4 percent and calls for an expansion of trade and foreign technology programs. A rise in loans, foreign

investment and joint ventures will be encouraged. Infrastructure improvements including railways, port construction, and education and social welfare programs will be upgraded. While it will be difficult to achieve 4-percent growth in the agricultural sector, the government anticipates increased production in food and other products. A halt to population growth is urgent if the population is to be kept at under 1.06 billion by 1985 in accord with the government's proposals.

In the 1983 budget, the state will be spending 14.5 percent on defense while expenditures for education, science, culture and public health increased by 11 percent to 16 percent of the total.

There have been some reforms to permit small-scale private ownership and incentive bonuses which have encouraged independent economic decisions and greater efficiency, but the new methods have also produced bureaucratic confusion and an uneven distribution of wealth. Granting some autonomy to provincial governments, for instance, stimulated their sense of responsibility, but at the same time created overlapping investments and hampered coordination. The government is also constrained by the lack of statistical data. During the Cultural Revolution, the national network of statistical offices was destroyed and the present staff is half the size it was in 1965.³

Moreover, according to informed sources, manipulation of the statistical data at both the local and national levels is rampant. A juggling of the number of births, total production levels, and amount of cultivable land is characteristic. As each commune, factory and provincial government is pressed to show that it has achieved the goals set by the central government, it is common practice to paper over certain failures in infrastructure investment, the number of employed workers, the size of inventory stocks and consumer price increases.

Trade

While Japanese exports to China last year fell by more than 30 percent to \$3.5 billion and imports were flat at \$5.4 billion, Japan is one of China's major trading partners. Japan's trade deficit with China last year was more than \$1.8 billion. Efforts to increase infrastructure investments and meet rising demand for consumer goods strengthened China's imports of steel from Japan last year, accounting for 36 percent of total exports. But demand for machinery and transportation equipment dipped to less than half the level of the previous year as the government ended outlays for industrial plants. Import restrictions on goods considered luxuries, i.e. television sets, automobiles, radio-cassette recorders, electronic calculators and wrist watches, reduced shipments of these goods. Exports of ships jumped eight-fold, including several tankers. Fertilizer exports fell, as did sales of textiles and apparel, but deliveries of plastics and synthetic rubber increased significantly.

Roughly 60 percent of Japan's imports from China consists of mineral fuels, primarily oil. Even though Japan's overall crude oil imports dropped by nearly 7 percent last year in volume terms, imports of Chinese oil remained at the same level, slightly more than 9 million metric tons, and petroleum products thus account for 53 percent of total imports from China. This pattern of exports of industrial products and imports of oil is not likely to change in the near future.

Plant Exports

Large-scale plant construction based on Japanese technical expertise is highly sought after in the developing countries. This kind of project usually involves a variety

of Japanese firms, including trading companies and financial institutions. After 1978, Japanese firms rushed to contract new plant exports with China and the ensuing cancellations and postponements reportedly cost businesses a staggering loss. The most publicized case involved the Baoshan steel mill near Shanghai. The project was criticized because it was seen as too sophisticated for a developing country and unlikely to contribute to the immediate demand for a higher standard of living — needs which would have been better met by investments in light industry and agriculture. Mainichi Shimbun reported last September, however, that Chinese trade officials were considering resuming construction, presumably referring to the Baoshan steel mill and two other petrochemical plants, although nothing specific has emerged.

According to China Newsletter,⁴ 23 plant export contracts have been concluded. The number of contracts increased in 1982 over the previous year, but the value per contract declined. Asahi Glass Co. Ltd. signed an agreement with Shaanxi Color Picture-Tube Factory to produce 100,000 monochrome tubes a month. Mitsubishi Heavy Industries, Ltd. and Ishikawajima-Harima Heavy Industries Co., Ltd. are involved in equipment for coal mining and port construction. Shanghai Petrochemical Complex, Murata Manufacturing Co. and Toko Bussan Co., Ltd. agreed to build a plant with a capacity of 10,000 tons of polyester filament a year. And Lanzhou Chemical Industrial Co. signed an agreement with Toyo Engineering Corp. and Marubeni Corp. for a plant to produce 5,000 tons of polystyrene.

Investment Projects

Until 1978, China refused to borrow foreign capital. However, with the acceleration of industrialization, imports of foreign technology and foreign investment were permitted. In 1979, Chinese officials began negotiating a yen loan for eight projects to develop rail transportation, ports and hydroelectric power plants. Eventually, six projects were approved and a ¥50 billion (\$200 million) loan was announced. Since then, all official yen loans have been invested in the same projects — a total of ¥296 billion (\$1.18 billion) at 3 percent annual interest with a 30-year payment period. The loans are a combination of capital credits and commodity loans.⁵

The Japan Export-Import Bank loans are categorized as private investment, but in fact, the bank is government chartered. From 1980 to 1982, the bank loaned ¥244 billion (\$980 million) to China, mostly for coal mining projects. In order to provide official loans to China, Japan negotiated with the OECD in 1978 to include China on its list of developing countries so that loans would come under Official Development Aid (ODA). Despite pressure from Peking, Japan had to take into account assistance to other Asian nations. The \$5.5-billion request from China would have exceeded the total amount of aid to all other Asian nations combined — politically, a risky situation for Japan. The final six projects to be implemented reflect national interests. Two projects, the Beijing-Qinhuangdao railway and Qinhuangdao port, both in the north, are directly connected with the expansion of coal transportation. The Yanzhou-Shijiusuo railway and port will also be used for coal exports. Japan obviously considered the export infrastructure weak. According to one analysis, another railway line that would run to Hong Kong was considered a problem because of the possibility that it might invite criticism about China's presence in the southern part of Asia, but it was finally accepted.⁶

Oil Exploration Projects

A Japanese-financed oil and gas drilling venture in the Bohai Bay was initiated in 1979 with the government underwriting 60 percent of the costs and the balance funded by private investors. Japan is responsible for offshore oil exploration and test drilling

as well as construction of production facilities, at which point the Chinese will take over operations. The Japan National Oil Corp. will receive 42.5 percent of the oil. Plans call for joint development of the oil fields (Japan-49 percent; China - 51 percent) with primary funding by the Japan Export-Import Bank. The estimated time span is five to seven years for exploration, and another five years to develop the site. During the contract negotiations, the Japanese side insisted on international procurement policies based on price-competitiveness, quality and delivery — a demand opposed by the Chinese who sought to confine purchases to indigenous materials.

The first high-quality pilot well was drilled in six months, and two later discoveries in the following year also produced a high-quality oil, equivalent to Arabian Light. Industry analysts, however, say that commercialization of the project will require ¥1 trillion (\$4 billion) in financing.⁷ American and European oil companies have also been involved in oil exploration in China. International bids to drill in the Yellow Sea and the South China Sea were submitted last August, and while Peking authorities assured the Japanese that they would take into account the special relationship between the two countries, no commitment was made.

Assessment

China's political climate dictates its economic environment. Economic policy has always been fought on an ideological basis, with the pragmatists pushing for industrialization and commerce with industrially advanced nations, and the ideologues battling to preserve communist principles and exclude foreign influences. The postwar history of China has been characterized by this confrontation.

In 1978, policy temporarily permitted accessing foreign technology. But three years later a political shift banning contact with foreigners eliminated a number of heavy industrial projects. The latest five-year plan does not call for radical policy changes but attempts to raise the standard of living while continuing to develop at a slower pace.

Perhaps the more fundamental problem is China's decision-making process. It has been widely reported that policy decisions are a reflection of personal power rather than institutional planning. Past experience suggests that political and economic policies might shift overnight. Ideological differences, regional background and political clout tend to create factional struggles that undermine the effectiveness of policy implementation. Widespread unemployment explains the nepotism and inefficiency of the workforce. Another urgent problem is the social integration of the generation who served as Red Guards during the Cultural Revolution. Many of these militants were banned to border provinces, but there are sporadic reports of youths who attempt to return and are rejected by the authorities.

In spite of everything, the overall bilateral relationship will continue to expand. More Chinese are being sent to Japan for training in engineering, transportation and management. Official contacts take place on a regular basis, and private businesses are slowly entering the Chinese market. Nevertheless, Asian nations have traditionally feared China's power and Japan should be sensitive to their reaction to what appears to be excessive support for China's economic development.

Footnotes

¹"Conference Communique on Japan-China Long-term Trade", September 1982.

²Ministry of International Trade and Industry, "White Paper on Economic Aid 1982" (Keizai Kyoryoku No Genjo To Mondaiten), p. 301.

³Yoichi Funahashi, "Neibu: A China Report" (Neibu: Aru Chugoku Hokoku), (Asahi Shimbunsha, 1983), pp. 266 - 269.

⁴Kazunori Mori, "Japan-China Trade in 1982 and the Outlook for 1983", (China Newsletter, March - April 1983), p. 5.

⁵MITI, White Paper, pp. 301 - 305.

⁶Kosaku Matsumoto, "External Elements of China's Economic Policy and Japan's Financial Assistance to China", (China Newsletter, January - February 1983), pp. 9 - 14.

⁷Ryo Inoue, "Analysis of Sino-Japanese Oil Development" (Nicchū Sekiyū Kaihatsu No Genjō To Tenbo), (MITI Journal, January 1982), pp. 108 - 112.

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Table 1: Japan's Major Trading Partners, 1978-82*

(in millions of dollars)

	1978		1979		1980		1981		1982	
	Value	Share	Value	Share	Value	Share	Value	Share	Value	Share
<u>Exports</u>										
Total	\$97,543	100.0%	\$103,032	100.0%	\$129,807	100.0%	\$152,030	100.0%	\$138,831	100.0%
United States	24,915	25.5	26,403	25.6	31,367	24.2	38,609	25.4	36,330	26.2
Saudi Arabia	3,254	3.3	3,829	3.7	4,856	3.7	5,876	3.9	6,621	4.8
West Germany	3,654	3.7	4,266	4.1	5,756	4.4	5,968	3.9	5,018	3.6
Korea	6,003	6.2	6,247	6.1	5,368	4.1	5,658	3.7	4,881	3.5
United Kingdom	2,341	2.4	3,097	3.0	3,782	2.9	4,789	3.2	4,813	3.5
Hong Kong	3,088	3.2	3,379	3.3	4,761	3.7	5,311	3.5	4,718	3.4
Australia	2,692	2.8	2,607	2.5	3,389	2.6	4,779	3.1	4,581	3.3
Singapore	2,325	2.4	2,679	2.6	3,911	3.0	4,468	2.9	4,373	3.1
Indonesia	2,095	2.1	2,124	2.1	3,458	2.7	4,123	2.7	4,261	3.1
Taiwan	3,585	3.7	4,337	4.2	5,146	4.0	5,405	3.6	4,255	3.1
U.S.S.R.	2,502	2.6	2,462	2.4	2,778	2.1	3,259	2.1	3,899	2.8
China	3,049	3.1	3,699	3.6	5,078	3.9	5,096	3.4	3,511	2.5
<u>Imports</u>										
Total	79,343	100.0	110,672	100.0	140,528	100.0	143,290	100.0	131,931	100.0
United States	14,790	18.6	20,431	18.5	24,408	17.4	25,297	17.7	24,179	18.3
Saudi Arabia	8,450	10.6	12,134	11.0	19,538	13.9	21,483	15.0	20,528	15.6
Indonesia	5,247	6.6	8,794	7.9	13,167	9.4	13,305	9.3	12,005	9.1
United Arab Emirates	2,622	3.3	3,633	3.3	8,190	5.8	8,836	6.2	7,983	6.1
Australia	5,300	6.7	6,298	5.7	6,982	5.0	7,419	5.2	6,961	5.3
China	2,030	2.6	2,955	2.7	4,323	3.1	5,292	3.7	5,352	4.1

*Rankings based on 1982 trade flows.

Source: Japan Tariff Association, Summary Report: Trade of Japan

Table 2: Japan's Trade with China, 1980-82

(in thousands of dollars)

	<u>1980</u>	<u>1981</u>	<u>1982</u>
<u>Exports</u>			
Chemicals	\$ 543,090	\$ 523,150	\$ 469,837
Metals and Metal Products	1,683,300	1,249,845	1,354,332
Steel	1,370,047	967,091	1,271,763
Machinery and Transport Equipment	2,146,665	2,433,392	1,067,107
Textiles and Apparel	403,880	599,425	367,913
Other	301,400	289,640	251,636
TOTAL	5,078,335	5,095,452	3,510,825
<u>Imports</u>			
Food	470,662	556,114	504,419
Mineral Fuels	2,376,618	2,935,059	3,061,365
Crude Oil	1,951,563	2,332,893	2,340,877
Chemicals	198,019	244,551	230,068
Textiles and Apparel	533,042	551,387	572,759
Other	745,033	1,004,698	983,806
TOTAL	4,323,374	5,291,809	5,352,417
Trade Balance	754,961	-196,357	-1,841,592

Source: Japan Tariff Association, Summary Report: Trade of Japan